THE DIRECTOR OF CENTRAL INTELLIGENCE

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National Intelligence Officers

NOTE FOR: Henry Rowen

FROM: Maurice Ernst

SUBJECT: Saudi Arabia and the Oil Market

1. It now appears likely that the official price of Saudi light crude will hold at $34 a barrel. Recent reporting from Saudi Arabia enables us to make a plausible reconstruction of the course of events.

2. As late as January, the Saudis did not expect a major problem in the oil market to develop this winter and spring. As Yamani's statements indicate, they believed that inventories were being drawn down so rapidly that the drawdown process would end by late winter or early spring at the latest. They also expected a recovery in the Western economies to begin during the second quarter, which would halt the decline in oil consumption and, together with the end of destocking, would start to push up the demand for OPEC oil.

2. These expectations were shattered during February by the accumulating evidence of continuing declines in oil consumption in the West and by increasingly pessimistic business cycle forecasts. Unexpectedly slack economic activity, especially in Europe and the United States, cut oil demand so rapidly that the rate at which excess inventories were being drawn down fell sharply. Like most observers, the Saudis now believe that the economic upswing will not begin until the third quarter, and consequently that the process of drawing down excess inventories will be stretched through at least the first half of the year.

3. In this extremely slack oil market, spot crude prices and the netback from spot prices of petroleum products fell several dollars below official crude prices. Although OPEC countries by and large held the line on official prices, Iran embarked on a new policy of substantially cutting prices to raise production and revenues, and non-OPEC countries also cut prices. The most serious break was the large recent British price cut, which made British crude much cheaper than that of comparable African crudes. The move was a surprise and indicated a policy shift, because in the past the UK had maintained approximate price parity with African crudes.

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4. Faced with this situation, the Saudi ledership must have considered various policy options, including allowing the price of Saudi benchmark crude to drop to $30 or even less. The major problem with such an option is that it would have been difficult for the Saudis to stop the downward price spiral once confidence in their determination to support a benchmark price had been undermined. Moreover, all the OPEC countries are aware that short term price elasticities of demand for oil are low, so that lower prices would mean substantially lower revenues for a considerable period of time. [redacted] 25X1 25X1

5. At some point during the past few weeks the Saudi leadership apparently decided to support the $34 benchmark price, but only on condition that other OPEC countries accept part of the burden of support. This means that some countries would actually cut production below current levels, while others would agree to refrain from increasing production. The Saudis were in no hurry, however, and apparently decided to let market pressure continue to soften up the other OPEC countries before agreeing to meet them at the bargaining table. The large UK price cut, which threatened becoming the trigger for a rapid unravelling of official OPEC prices, probably precipitated the Saudi agreement to participate in a special OPEC meeting, which is scheduled for 19 March.

6. Reporting on the results of an informal rump meeting at Doha and on subsequent discussions suggests that most of OPEC will approve the Saudi plan. Iraq, Kuwait, and Venezuela will reduce production while most others will pledge themselves not to increase theirs. Overall, OPEC countries other than Saudi Arabia would agree to a production ceiling of around half a million b/d below the February level (around a million b/d below the January level). For its part, Saudi Arabia will agree to cut production sufficiently to support the $34 benchmark price. The 7.5 million b/d production rate announced by the Saudis is a ceiling, not a floor. The Saudis almost certainly expect to cut production below that rate until the demand for OPEC oil begins to recover. What they wanted, and apparently got, was an agreement from the others to share some of the burden and not to take advantage of Saudi actions.

7. Iran and Libya apparently have not agreed to the Saudi plan. They are allowed some increase in production, however, and whether they could do much better, given their management problems, is uncertain.

8. Assuming the OPEC agreement holds, we would expect the oil market to remain soft until excess inventories are drawn down, and then to begin to firm. Once it becomes clear to the market that the Saudis intend to support the $34 price, the spot price of crude will probably begin to recover.

9. In the longer term, an end to the Iran-Iraq war could still create severe downward pressure on the oil market. In that event a new OPEC agreement to limit production would probably become necessary. If the agreement holds, however, it may be easier in the future to develop and implement at least a rough-hewn pro rationing system to cope with declining markets.

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